Proposed statement of position : Accounting for derivative instruments and hedging activities by not-for-profit health care organizations, and clarification of the performance indicator;Accounting for derivative instruments and hedging activities by not-for-profit health care organizations, and clarification of the performance indicator; Exposure draft (American Institute of Certified Public Accountants), 2002, June 14

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

EXPOSURE DRAFT

PROPOSED STATEMENT OF POSITION

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES BY NOT-FOR-PROFIT HEALTH CARE ORGANIZATIONS, AND CLARIFICATION OF THE PERFORMANCE INDICATOR

June 14, 2002

Prepared by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants

Comments should be received by August 13, 2002, and sent by electronic mail to aschumacher@aicpa.org, or addressed to Annette Schumacher Barr, Technical Manager, Professional Standards and Services, File 2850.PH, AICPA, 1455 Pennsylvania Avenue, NW, Washington, DC 20004-1081.

June 14, 2002

Accompanying this letter is an exposure draft of a proposed Statement of Position (SOP), *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator.* A summary of the proposed SOP follows this letter.

The purpose of this exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.

The proposed SOP provides guidance with respect to how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended, and clarifies certain matters with respect to the performance indicator (earnings measure) reported by such organizations. It would amend the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide).

Comments are specifically requested on the following issues addressed by this exposure draft:

Performance Indicator

Subsequent to the issuance of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, the FASB indicated that use of the term *net income* to describe an earnings measure of a not-for-profit organization is not appropriate. This is because *net income* by definition includes amounts representing discontinued operations, extraordinary items, and changes in accounting principle, while any earnings measure reported by a not-for-profit organization must exclude those items.

The term *performance indicator* was introduced in the AICPA's 1996 revision of the health care industry audit guide.[1] The Accounting Standards Executive Committee (AcSEC) intended that the linkage between the new *performance indicator* measure and the traditional earnings measure be preserved to the greatest extent possible. However, the provisions of paragraphs 10.17 and 10.18 of the Guide (which define *performance indicator*) are not consistently interpreted in that manner by users of the Guide. In addition, when new accounting standards are issued, some users of the Guide are uncertain how to apply them with respect to the performance indicator. Paragraph 9 of the proposed SOP would revise the Guide to state explicitly that the *performance indicator* should be regarded as the functional equivalent of *income from continuing operations* of a for-profit enterprise. Do you believe that this clarification will be useful to preparers, auditors, and users of financial statements in applying the provisions of the Guide and other authoritative accounting literature to financial statements of not-for-profit health care organizations? If not, why not?

[1] *Health Care Organizations* replaced the AICPA Industry Audit Guide *Audits of Providers of Health Care Services* in 1996.

Effective Date and Transition

This proposed SOP presents unique transition challenges. Certain not-for-profit health care entities may, because of their interpretation of authoritative literature, have had economic hedges that they did not designate as cash flow hedges because they did not believe that cash flow hedging derivatives were accounted for differently from nonhedging derivatives. AcSEC recognized that the historical actions taken by those entities to document, designate, or assess hedge effectiveness may have differed if this proposed SOP had been effective at the outset of an existing derivative transaction. However, because FASB Statement No. 133 forbids retroactive designation of a hedge, AcSEC cannot make hedge accounting retroactively available to entities that did not take those actions and that followed accounting practices that differ from those set forth in this SOP.

Consequently, AcSEC determined that entities that have followed accounting practices that differ from those set forth in this proposed SOP should be required to apply the provisions of the SOP prospectively, with no reclassification of derivative gains or losses upon adoption of the SOP. However, in the year of adoption, those entities should disclose what the performance indicator reported would have been if the prior year reporting practices had continued to be applied. Do you agree with the proposed transition requirements? If not, what other transition guidelines should be provided and why? Do you believe that the proposed disclosure related to the prospective approach adequately addresses concerns regarding comparability of financial statement information? If not, why not?

AcSEC intends to issue a final SOP late in the fourth quarter of 2002. To ensure the comparability of the information contained in the disclosure described in the preceding paragraph, AcSEC precluded entities from adopting the SOP in interim periods of a fiscal year. AcSEC recognized, however, that this prohibition may place entities with fiscal years other than a calendar year at a disadvantage. Do you believe that early adoption as of the first day of an interim period beginning after December 15, 2002 should be allowed? If so, how would you modify the pro forma disclosure described in the preceding paragraph to provide comparable financial statement information?

AcSEC welcomes comments or suggestions on any aspect of this exposure draft. When making comments, please include reference to specific paragraph numbers, including reasons for any comments or suggestions, and provide alternative wording where appropriate.

Comments on the exposure draft should be sent by electronic mail to aschumacher@aicpa.org, or addressed to Annette Schumacher Barr, Technical Manager, Professional Standards and Services, File 2850.PH, American Institute of Certified Public Accountants, 1455 Pennsylvania Avenue, N.W., Washington, DC, 20004, in time to be received by August 13, 2002.

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SUMMARY

This Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide) to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended. The SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.

- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.

The provisions of the SOP are effective for fiscal years beginning after December 15, 2002. The provisions of the SOP should be applied prospectively as of the beginning of a fiscal year. Not-for-profit health care organizations that reported derivative gains or losses in a manner inconsistent with the conclusions of the SOP in financial statements issued prior to adoption of the SOP are not permitted to reclassify those gains or losses upon adoption. Those organizations are required to disclose in the notes to the financial statements what the performance indicator reported in the year of adoption would have been if the reporting practices followed before adoption of this SOP had continued to be applied.

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FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the documents.

STATEMENT OF POSITION

ACCOUNTING FOR DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES BY NOT-FOR-PROFIT HEALTH CARE ORGANIZATIONS, AND CLARIFICATION OF THE PERFORMANCE INDICATOR

INTRODUCTION

1. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended, establishes accounting and reporting standards for derivative instruments and hedging activities. If certain conditions are met, a derivative may be specifically designated as a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment (fair value hedge), a hedge of the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction (cash flow hedge), or a hedge of foreign currency exposure.[1]

2. The accounting for derivative gains and losses depends on the intended use of the derivative and the resulting designation.

- For a fair value hedge, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged.

- For a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings when the forecasted transaction affects earnings. Any ineffective portion of the gain or loss is reported in earnings immediately.

- For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

3. The application of FASB Statement No. 133 to entities that do not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization) is described in paragraph 43 of that Statement. Paragraph 43 indicates that such organizations shall recognize the gain or loss on hedging and nonhedging derivative instruments, and changes in the carrying amount of the hedged item in a fair value hedge, as a change in net assets in the period of change. Paragraph 43 also indicates that cash flow hedge accounting is not available to a not-for-profit or other entity that does not report earnings as a separate caption in a statement of financial performance. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* FASB Statement No. 133 does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

4. Many health care entities are organized as not-for-profit organizations, and thus would appear to be subject to the provisions of paragraph 43 of FASB Statement No. 133. The thrust of the guidance in paragraph 43 appears to be directed at the fact that FASB Statement No. 117 does not require not-for-profit entities to report earnings. However, not-for-profit health care organizations must report a defined measure of earnings (performance indicator) as a separate caption in the statement of operations, based on requirements contained in paragraphs 10.17 and 10.18 of the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide). Consequently, some not-for-profit health care organizations believed that paragraph 43 of FASB Statement No. 133 (including its

[1] Not-for-profit health care organizations do not enter into foreign currency hedges frequently. Therefore, this Statement of Position focuses on matters pertaining to fair value and cash flow hedges.

provisions related to cash flow hedge accounting) did not affect them. Those entities applied the provisions of FASB Statement No. 133 in the same manner as for-profit enterprises. Other not-for-profit health care organizations believed they were subject to the guidance in paragraph 43, but interpreted that guidance in different ways. As a result, diversity in practice arose among not-for-profit health care organizations with respect to their accounting for derivatives.

5. This Statement of Position (SOP) addresses how not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133 and clarifies certain matters with respect to the performance indicator (earnings measure) reported by such organizations.

SCOPE

6. This SOP applies to not-for-profit health care organizations that are within the scope of the Guide. It does not apply to governmental entities that are within the scope of the Guide.

CONCLUSIONS

Application of FASB Statement No. 133

7. Except as provided in paragraph 8 of this SOP, not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises. That is, the gain or loss items that affect a for-profit enterprise's income from continuing operations similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that are excluded from a for-profit enterprise's income from continuing operations (such as items reported in other comprehensive income) similarly should be excluded from the performance indicator by the not-for-profit health care organization.

8. Paragraph 47 of FASB Statement No. 133 discusses requirements to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income.* Although not-for-profit health care organizations are not subject to the requirements of FASB Statement No. 130, this SOP requires those organizations to separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (also see paragraph 10), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133. Similarly, this SOP requires not-for-profit health care organizations to provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date.

Performance Indicator

9. Paragraphs 10.17 and 10.18 of the Guide are amended as follows. The following text is added after the first sentence of paragraph 10.17:

> This performance indicator and the income from continuing operations reported by for-profit health care enterprises generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care

enterprises typically would not receive contributions, and not-for-profit health care organizations would not award stock compensation). That is, the performance indicator is analogous to income from continuing operations of a for-profit enterprise.

In paragraph 10.18, item e is eliminated, item f is renumbered e, and item g is deleted and replaced with the following two subpoints:

f. Items that are required to be reported in or reclassified from other comprehensive income, such as minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*; foreign currency translation adjustments; and the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments.

g. Items that are required to be reported separately under specialized not-for-profit standards. These include extraordinary items, the effect of discontinued operations, and the cumulative effect of accounting changes pursuant to the provisions of FASB Statement No. 117; and unrealized gains and losses on investments not restricted by donors or by law (except for those investments classified as trading securities) and investment returns restricted by donors or by law, as required by paragraphs 4.07 through 4.10 of this Guide.

EFFECTIVE DATE AND TRANSITION

10. The provisions of this SOP are effective for fiscal years beginning after December 15, 2002. This SOP should be applied prospectively as of the beginning of a fiscal year for all contracts existing on the initial date of application of this SOP and for transactions after that date. Derivative gains or losses reported in a manner inconsistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP should not be reclassified upon adoption. Any derivative gains and losses excluded from the performance indicator in the financial statements issued for fiscal years ended before the initial date of application of this SOP that did not meet the cash flow hedging criteria of FASB Statement No. 133 should not be reclassified and included as a component of the performance indicator in any period subsequent to the initial date of application of this SOP. In addition, the derivative gains and losses referred to in the preceding sentence should not be included in the disclosure of the accumulated derivative gain or loss described in paragraph 8. However, to the extent that derivative gains or losses on cash flow hedges qualifying under FASB Statement No. 133 had been reported in a manner consistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP, such amounts should be included in that disclosure and should be reclassified and included in the performance indicator when the hedged item affects the performance indicator. Not-for-profit health care organizations that reported derivative gains or losses in a manner inconsistent with the provisions of this SOP should disclose in the notes to the financial statements what the performance indicator reported in the year of adoption would have been if the reporting practices followed before adoption of this SOP had continued to be applied.

11. Entities initially applying hedge accounting upon adoption of this SOP are reminded that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied. Derivative instruments should not be retroactively designated as hedges if appropriate contemporaneous documentation of the election and periodic assessment of effectiveness did not occur in conformity with FASB Statement No. 133.

BACKGROUND

12. Issues surrounding the reporting of derivatives by not-for-profit health care organizations and the resulting diversity in practice were brought to the attention of the planning subcommittee of the AICPA's Accounting Standards Executive Committee (AcSEC) in December 2000. Specifically, questions had been raised about whether the guidance in paragraph 43 of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended, applied to not-for-profit health care organizations that are required under industry-specific generally accepted accounting principles (GAAP) to report a performance indicator.

13. The planning subcommittee discussed the paragraph 43 issue and concluded that, because not-for-profit health care organizations are required to report a standardized performance indicator that is considered analogous to income from continuing operations reported by for-profit enterprises, they should apply the provisions of FASB Statement No. 133 in the same manner as do for-profit enterprises. Because that conclusion was not considered controversial, the planning subcommittee directed the AICPA staff to draft clarifying guidance in the form of a proposed AICPA Technical Practice Aid (TPA).

14. The planning subcommittee also discussed a footnote that had been added as a conforming change to paragraph 10.18 of the Guide in May 2000. That footnote contained the following statement:

> Not-for-profit health care organizations that have early-adopted FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* should also report unrealized gains and losses on derivatives that do not qualify as a fair value hedge under FASB Statement No. 133, except for the effect of changes in interest accruals, separate from the performance indicator....

In light of the planning subcommittee's conclusion that the provisions of FASB Statement No. 133 should be applied to not-for-profit health care organizations in the same manner as for-profit enterprises, it was decided that the May 2000 conforming change should be deleted from future editions of the Guide.

15. In January 2001, the planning subcommittee discussed a letter received by AcSEC's Chair from The Bond Market Association (TBMA). The letter indicated TBMA's awareness of the planning subcommittee's discussions and expressed concern that the proposed guidance would be issued in the form of a nonauthoritative TPA. TBMA was concerned that not-for-profit health care organizations and their independent auditors would not be aware of such guidance, resulting in the inconsistent application of derivative accounting among organizations in the sector. TBMA also wanted to ensure that all affected parties would have an opportunity to review and comment on the proposed guidance, because it could represent a significant change in reporting for some not-for-profit health care organizations.

16. In March 2001, after further discussing the draft TPA and considering input received from various sources, the planning subcommittee and AcSEC decided that a Statement of Position (SOP) should be issued to amend the Guide to address these issues. Although the planning subcommittee and AcSEC did not disagree with the conclusions in the draft TPA, it was concluded that an SOP subject to due process would be the most appropriate vehicle for communicating the guidance.

Views on the Issue

17. Some believed that because not-for-profit health care organizations are required by the AICPA Audit and Accounting Guide *Health Care Organizations* to report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, they should apply the provisions of FASB Statement No. 133 (including the cash flow hedge accounting provisions) in the same manner as for-profit enterprises. That is, the gain or loss items that under FASB Statement No. 133 would affect a for-profit enterprise's earnings similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that under FASB Statement No. 133 are reported in other comprehensive income by the for-profit enterprise similarly should be excluded from the performance indicator by the not-for-profit health care organization. They interpreted paragraph 43 of FASB Statement No. 133 as applying only to organizations that are not required to report an earnings measure.

18. Others believed that paragraph 43 precludes the use of cash flow hedge accounting by not-for-profit health care organizations because the FASB has not defined the performance indicator to be used by those organizations. They cited the following sentence in paragraph 501 of FASB Statement No. 133 as support for their position:

> For this Statement to permit a not-for-profit entity, for example, to apply cash flow hedge accounting, the Board would first have to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise.

They believed that the definition of *performance indicator* used by not-for-profit health care organizations does not qualify as earnings for FASB Statement No. 133 purposes because it was promulgated by AcSEC, rather than the FASB. Opponents of that view pointed to paragraph 49 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations,* which allows AICPA industry Audit and Accounting Guides to provide implementing guidance with respect to that Statement that, if cleared by the FASB, should be adopted by users of those guides. The FASB did not object to the definition of *performance indicator* promulgated in the Guide.

19. Others acknowledged that not-for-profit health care organizations report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, but believed that the cash flow hedge accounting prohibitions in paragraph 43 should apply because the concept of other comprehensive income is limited to for-profit enterprises that are subject to FASB Statement No. 130, *Reporting Comprehensive Income.* Opponents of that view responded that not-for-profit health care organizations employ other comprehensive income reporting concepts in their statement of operations and their definition of a performance indicator. They pointed to the fact that among the exclusions from the performance indicator listed in paragraph 10.18 of the Guide are the items that for-profit organizations are required to include in other comprehensive income under FASB Statement No. 130 (foreign currency items, minimum pension liability adjustments, and unrealized gains and losses on certain investments in debt and equity securities). Further, they pointed to paragraphs 500 and 501 of FASB Statement No. 133, which indicate that the total change in net assets of a not-for-profit organization is analogous to total comprehensive income of a for-profit enterprise.

20. Still others believed that, although not-for-profit health care organizations conceptually are capable of applying the mechanics of cash flow hedge accounting in their financial statements, they are precluded from doing so because the list in paragraph 10.18 of the Guide of items to be excluded from the performance indicator does not explicitly include "the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments." They

believed that all transactions except those explicitly listed in paragraph 10.18 should be included in the performance indicator.

21. Among those who believed that paragraph 43 prohibits not-for-profit health care organizations from applying cash flow hedge accounting, some believed that all hedging and nonhedging derivative gains and losses should be included in the performance indicator. Others interpreted paragraph 43 as requiring all hedging and nonhedging derivative gains and losses to be excluded from the performance indicator and reported in “other changes in net assets.” Still others employed a hybrid approach to reporting derivative gains and losses based on guidance provided in a conforming change (that subsequently was rescinded[2]) contained in a footnote to paragraph 10.18 of the May 2000 edition of the Guide.

BASIS FOR CONCLUSIONS

Scope

Other Not-for-Profit Organizations

22. AcSEC discussed whether the scope of the SOP should extend to other types of not-for-profit organizations (that is, not-for-profit organizations other than health care organizations) in situations where those organizations voluntarily choose to provide a performance indicator. Those organizations are subject to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations,* rather than the Audit and Accounting Guide *Health Care Organizations.* AcSEC chose not to address similar issues for those organizations in the context of this SOP because, unlike health care organizations, other types of not-for-profit organizations are not subject to a standardized or prescribed performance measure.

Governmental Health Care Enterprises

23. Because the concept of reporting "other comprehensive income" conflicts with the reporting requirements of GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments,* cash flow hedge accounting is not available to governmental health care enterprises that are within the scope of the Guide. Therefore, governmental health care enterprises are excluded from the scope of the SOP. FASB Statement No. 133 applies to governmental enterprises only to the extent that provisions in that Statement do not conflict with the provisions of GASB pronouncements (see paragraph 94 of GASB Statement No. 34).

Reporting a Separate Component of Equity

24. Pursuant to paragraph 26 of FASB Statement No. 130, for-profit entities report *accumulated other comprehensive income* as a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position. When FASB Statement No. 130 was issued, the FASB considered whether not-for-profit organizations should also be included within the scope of that Statement. The Board decided to exclude those organizations, noting that not-for-profit organizations' financial statements already were displaying the equivalent of comprehensive income as a result of the requirements of FASB Statement No. 117. Thus, not-for-

[2] See paragraph 14.

profit organizations are not required to report accumulated other comprehensive income as a separate component of equity.

25. AcSEC discussed whether the absence of a requirement to report accumulated other comprehensive income as a separate component of equity was a significant enough difference to preclude not-for-profit health care organizations from being able to use cash flow hedge accounting under FASB Statement No. 133. AcSEC determined that the concept of reporting accumulated other comprehensive income as a separate component of equity is unique to for-profit enterprises that report retained earnings and additional paid-in capital and that, further, the concept primarily appears to be a carryforward of the reporting practices followed by such entities before the issuance of FASB Statement No. 130. Moreover, AcSEC was concerned that such reporting may conflict with the provisions of FASB Statement No. 117 requiring not-for-profit organizations to report three classes of net assets (unrestricted, temporarily restricted, and permanently restricted). Therefore, AcSEC concluded that the absence of a requirement to report a separate component of equity in the balance sheet of not-for-profit health care organizations should not preclude those organizations from using comprehensive income reporting for qualifying gains and losses on cash flow hedges. Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care organization's net assets, there is no compelling need for it to be reported separately in the balance sheet.

Income Statement Classification of Derivative Gains and Losses

26. Although FASB Statement No. 133 provides comprehensive disclosure guidance for derivatives, it does not explicitly address or prescribe the income statement classification for derivative gains and losses that are included in earnings.

27. Paragraph 45 of FASB Statement No. 133 requires an entity to disclose where in the income statement it has chosen to report the net gain or loss on fair value and cash flow hedges (and the related hedged transaction or item), but the paragraph does not specify where or in what captions such gains and losses should be displayed. That allows for flexibility in reporting based on an entity's economic rationale for entering into the hedge. For derivatives that are not designated as hedges, FASB Statement No. 133 does not require disclosure of where gains and losses are reported in the income statement, nor does it specify where within the income statement those gains and losses should be reported. AcSEC decided not to provide more specific guidance regarding income statement classification in this SOP because it did not want to prescribe more restrictive guidance for not-for-profit health care organizations than that applicable to other organizations subject to FASB Statement No. 133.

Definition of Performance Indicator

28. The term *performance indicator* was introduced in 1996 when the AICPA issued the Audit and Accounting Guide *Health Care Organizations.*[3] The 1996 revision of the industry Guide was necessitated largely by the issuance of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made,* and No. 117, which (among other things) changed the financial statement display requirements for not-for-profit organizations. The 1995 exposure draft of the Guide had referred to the earnings measure using terms such as *net income* and *operating income*. The FASB subsequently objected to that terminology, deeming it inappropriate for describing an earnings measure of a not-for-profit organization. Accordingly, the final Guide used the generic term *performance indicator* to denote the earnings measure.

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[3] *Health Care Organizations* replaced the AICPA Industry Audit Guide *Audits of Providers of Health Care Services.*

29. Paragraph 1.04 of the Guide states, in part:

> The financial reporting for not-for-profit, business-oriented organizations and investor-owned health care enterprises generally is consistent except for transactions that clearly are not applicable. For example, not-for-profit business organizations would have nothing to report for shareholders' equity. On the other hand, investor-owned health care enterprises typically would not have anything to report for contributions.

Consequently, in developing the definition of *performance indicator* (paragraphs 10.17 and 10.18 of the Guide), AcSEC intended that the linkage between the new performance indicator measure and the earnings measure previously reported by not-for-profit health care organizations be preserved to the greatest extent possible, due to its importance to users of health care organizations' financial statements. The phrase "other items that are required by GAAP to be reported separately" was included in paragraph 10.18(g) of the Guide to enable the performance indicator to remain "evergreen," that is, to permit it to be updated by conforming changes to incorporate the issuance of future accounting standards.

30. This SOP amends paragraph 10.18 to clarify that the reference to "other items that are required by GAAP to be reported separately" refers to GAAP applicable to for-profit enterprises (for example, items that are required under existing accounting standards to be reported in other comprehensive income[4]) as well as GAAP specific to not-for-profit organizations, and that additional items may result from issuance of future accounting standards.

Transition

31. Paragraph 515 of FASB Statement No. 133 states, in part:

> Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate.

Similarly, Derivatives Implementation Group Issue No. K5, *Transition Provisions for Applying the Guidance in Statement 133 Implementation Issues,* indicates that when an entity has applied "the recognition and measurement of derivatives differently than required by subsequently issued cleared implementation guidance, [the entity] should account for the effects of initially complying with that implementation guidance prospectively for all existing contracts and future transactions, as of the effective date for that guidance." Consequently, AcSEC determined that the effects of initially complying with the guidance in this SOP should also be accounted for prospectively.

32. AcSEC also considered whether to allow an alternative for retroactive application of this SOP. Although this SOP does not change the "recognition and measurement of derivatives," it may change an entity's accounting policy and thus may affect certain actions taken by an entity. Therefore, the historical actions undertaken to document, designate, or assess effectiveness by entities that, in prior periods, had adopted accounting policies inconsistent with those set forth in this SOP could have been different had this SOP been effective during those prior periods. In recognition of this fact, and because hedging relationships cannot be documented retroactively under FASB Statement No. 133, AcSEC decided that retroactive application of the provisions of this SOP was not appropriate. Because the effect on the financial statements of a health care organization's hedging activities in the initial year of adoption of this SOP may not be comparable to

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[4] For example, in June 1997 the phrase "minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions,* or foreign currency translation adjustments" was added to paragraph 10.18(g) as a conforming change necessitated by the issuance of FASB Statement No. 130, *Reporting Comprehensive Income.*

the preceding year, AcSEC decided to require that not-for-profit health care organizations disclose the effect on the current year's performance indicator of continuing to apply the prior year's reporting practices. To ensure the comparability of the information contained in this disclosure, AcSEC further decided to require entities to adopt the SOP as of the beginning of a fiscal year.

33. AcSEC observed that some not-for-profit health care organizations may have employed a methodology that excluded derivative gains and losses from the performance indicator until those gains or losses were realized. Upon realization, those organizations would have recognized the derivative's gain or loss in the performance indicator. Consistent with its decision to require prospective application of this SOP, AcSEC decided that upon initial application of this SOP, any prior gains or losses on derivative instruments recognized by those not-for-profit health care organizations that had been excluded from the performance indicator in years before adoption and that did not meet the hedging criteria of FASB Statement No. 133 (including the requirements of contemporaneous documentation and testing of effectiveness) should not subsequently be reclassified and included as a component of the performance indicator. Rather, any such derivative gains and losses should be permanently excluded from the performance indicator.

34. AcSEC did agree, however, that to the extent that a not-for-profit health care organization had reported derivative gains or losses in a manner consistent with the provisions of this SOP (including compliance with the documentation and designation requirements of FASB Statement No. 133) in financial statements for periods prior to the initial application of this SOP, such amounts should be reclassified and included in the performance indicator when the hedged item affects the performance indicator